APPROACHES AND PROBLEMS IN MERGING COOPERATIVES

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APPROACHES AND PROBLEMS IN MERGING COOPERATIVES

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Mergers among cooperatives often are difficult and slow. Ownership is held by a large number of members and control is diffused as each usually has only one vote in the affairs of the association.

"Merger" here is considered in the broad sense of unifying or combining associations through either merger, consolidation, or acquisition.

Technically, a merger is an absorption of one association by another which retains its corporate identity. A consolidation is a union of two or more organizations which results in the creation of a new association and the termination of those consolidating. An acquisition is the purchase of an organization's assets by another association. In actual practice the effect of all three often is practically the same.

The problems discussed here are principally those encountered in attempting to achieve a merger. Let us emphasize again that not necessarily all of these are likely to be encountered in any one situation and that the relative importance of each will vary from merger to merger.

Sometimes there will be more problems after a merger than before in meshing the two or three cooperatives together into a smooth, efficient operation.

Some of the problems after merger may include extra, but nonrecurring, costs of making corporate changes and remodeling or closing facilities, delays in exchanging stock or equities in the individual associations for those of the merged one, and keeping boards or committees of each association fully and currently informed. Also, competition in the area may become keener after the merger. Thus members should be informed that real benefits may not be realized until the second or third year after combining.

In summary, our observations on mergers have emphasized the importance of an "organized way of

looking at things." Such an approach involves observation, verification, testing, experimentation, and coming to conclusions about alternate courses of action. It is a tool to help us evaluate problems arising in a given situation and as such it can help management project the most realistic course of future action.

Two areas where this approach seems especially important in considering cooperative mergers are size of business operation and human relations. As to size, we have examined the implications of what economists like to call "economies of scale" and "diseconomies of scale." These were examined in terms of the things that make up a cooperative--the products it handles, the services it performs, the facilities it operates, and the financial requirements it has.

Cooperatives are organizations of people and, therefore, we need to have a better understanding of human behavior and people-to-people relationships.

Undergirding all discussions and decisions should be the basic question: Will a merger achieve one or more of the following--increase net returns on farm products, reduce costs of supplies, or improve cooperative services to members?

Framework for Examining MERGERS

We all know that cooperatives have distinct business features--that they operate on a cost basis, that they are controlled by members, and that they limit returns on capital.

Especially important to us in this examination of mergers, however, is the fact that a cooperative is a

combination of many things. It handles various products, provides services, operates facilities, uses capital, and last, but not least, it includes people--both members and employees.

In this exploration of cooperative mergers, we consider the impacts of such mergers on the things that go to make up a cooperative.

In the final analysis, the interest of cooperative leaders in merger centers on what action will accomplish for members.

Background Considerations

In analyzing problems relating to the merger of cooperatives, their leaders should consider how changing economic, political, and social conditions may influence such merger. In other words, these leaders ought to look at the environment in which the proposed merger may occur. Perhaps they can best do this by making assumptions about these changing conditions.

These assumptions have basic implications as to prospects for merger. They might well include: (1) Prospects for world peace, (2) health of the economy, (3) conditions of agriculture, and (4) special conditions affecting the product and services the cooperatives concerned are planning to provide.

A hard look at assumptions suggests that cooperatives are confronted with a number of alternatives. These prospects for peace may indicate a stabilizing situation and increased world trade in agricultural products. In contrast, they may experience increased conflict with greatly intensified but somewhat controlled business activity.

When examining health of the economy, we ought to consider the possibilities of increased inflation as contrasted with the implications of adjustments that the achievement of peace in the world's trouble spots would introduce.

Likewise, the changing conditions of agriculture suggest the need for evaluating future policies. To what extent will we continue to be confronted with surpluses and low prices, or to what degree will we be developing an agricultural policy aimed at banishing hunger from large segments of the world's population?

Finally, we also should consider the special conditions facing a given cooperative. It would be quite safe to assume, for instance, in the Washington and Baltimore areas that increased urbanization will mean fewer farm members for local cooperatives with a projected decline in the volume of farmer business.

Approaching the Problem

It will help us to gain a better understanding of the problems of merger if we next consider how people approach problems. On the one hand, there are those who are overawed by the complexity of the changes and adjustments that confront them. They may be inclined to feel that there is not much they can do about these changes and adjustments. To them, events largely seem to be in the hands of the gods and consequently they believe they may as well act on hunches when making decisions on proper courses of action.

On the other hand, there are those who believe that man is a reasoning individual, that it is possible for him to look at the problems he deals with from the standpoint of what some people like to call organized common sense. They hold that as a reasoning being, man has the power to: (1) Observe developments, (2) verify results, (3) check on the degree to which events repeat themselves, (4) carry on experiments to get the facts, and (5) come to conclusions about alternate courses of action.

When we put our reasoning power to work in this way, we are able to draw conclusions, or at least to make educated guesses, as to what we can expect to happen. Given the facts and the situation, our reasoning power should help us understand, predict, and even control the future to some extent.

Application to Size and People

At least two areas should be examined by cooperative leaders to arrive at a better understanding of what merger may mean to them. The first relates to the impacts a larger size, achieved through merger, can have on business operations. The second relates

to people and how understanding human behavior might help us.

These areas are related because people are concerned with size and their behavior can influence the size that cooperatives are able to achieve by merger. Ideas as to the influences of size and human behavior, then, can help us arrive at a better understanding of what cooperatives can and cannot accomplish through merger.

These observations come as a result of a number of cooperative merger studies made by Farmer Cooperative Service. These studies raised a number of interesting questions:

If there was one cooperative instead of two, would operating costs be less?

Could lower costs be achieved by using facilities and labor to greater advantage, or by constructing modern plants?

Would it be possible to increase market power?

Could new services be added?

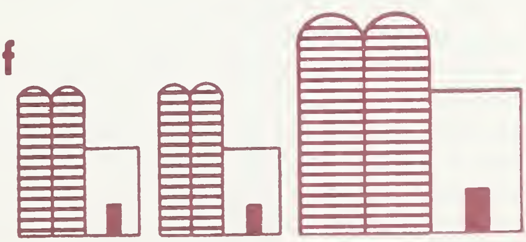
Would it be possible to make better use of financial resources?

How about people--when could they be relied on to support the idea of merger?

When would they be likely to stand in the way of merger?

These and other questions arose time and time again in successive merger studies. By observation, verification and testing, and research, it was possible to draw conclusions as to the effect of size on cooperatives.

Impacts of Size of Business



We know that merger means fewer but larger cooperatives. Let us, therefore, look at the implications of increased size on the various things that go to make up a cooperative: Products, services, facilities, and finance.

Possible Benefits

Size introduces an idea, dear to the hearts of economists, that is known as "economies of scale." Economies of scale in actual practice mean that with a given increase in size, it is possible to increase returns by carrying on operations at lower cost.

Applied to cooperatives, this idea means two things: (1) It will be possible for them to be more efficient in doing jobs they are already doing, or (2) increased volume may enable them to go into new undertakings.

Let us now consider the effects of greater size on products cooperatives handle.

Products Handled

Usually the combined volume resulting from merger will enable most cooperatives to reduce costs. For example, a feed milling cooperative having members who use 10,000 tons of feed annually is likely to be quite inefficient in providing this feed.

In the first place, a feed mill manufacturing this volume would only operate part time and its costs would be high. If the cooperative had no mill, it likely would be at a disadvantage in going into the market and buying this volume.

However, should three cooperatives, each having a need for 10,000 tons of feed merge, the resulting organization would be able either to operate an existing plant at full capacity and thus reduce costs, or to build a modern pushbutton mill capable of operating with greater efficiency.

The increased volume that results from merger also gives a cooperative increased market power. To be able to sell 20 million bushels of grain rather than 5 million bushels enables it to meet the needs of larger buyers and to join with others in exploring the possibilities for new and enlarged markets.

Cooperatives have learned from experience that the export business in grain and cotton is a big one. In the case of grain and soybeans and cotton products, individual regional cooperatives have found it necessary to join together to set up special cooperatives to develop foreign markets.

Another advantage of size is the ability it gives a cooperative to maintain quality. It can do this in several ways. First of all, it is possible to provide quality control. Second, by operating over a wider area it is easier to have on hand the quality and quantity of products needed to deal with large-scale buyers who purchase on a specification basis.

Services Provided

Increased size will enable many cooperatives to either provide many services more efficiently or undertake new ones that previously would not have been possible. This may mean sufficient volume to justify building storage facilities and providing transportation services. It also may mean doing sufficient credit business with patrons to justify the cooperative in providing credit services.

Another important service that can more readily be provided as cooperatives grow in size is that of research. Two associations each reporting an annual volume of $10 million may not believe that they are justified in undertaking research to help assure themselves of maintaining a pace-setting position. However, by combining resources they find it possible to provide such services economically.

Economies of scale, when applied to cooperatives, in actual practice may be the basis for their providing such services as fertilizer application, delivery of petroleum products, painting and spraying, custom use of machinery, and feed grinding.

Providing local fieldmen is another service that may be more feasible as cooperatives become bigger. In this way, regionals may assist local affiliates in improving various aspects of their operations by use of fieldmen. Local associations may be able to add fieldmen to help member producers in their farming operations.

With size also comes ability to consider opportunities for providing or supporting newer types of cooperative services such as forestry associations, livestock feeder lots, grazing associations, and recreation cooperatives.

Facilities

It is well known, too, that cooperatives need a minimum amount of products to justify manufacturing and processing. Merger makes it possible for cooperatives to achieve the size necessary to carry on such operations.

This is true, for example, in storing grain, in refining petroleum products, and in building fertilizer plants. The experience of the former G.L.F., now Agway Inc., Syracuse, N.Y., in integrating operations to provide for fruit and vegetable processing is an illustration of how merger enables cooperatives to add such facilities and increase services for members.

Merger also enables associations to write off outmoded facilities. Again, we may draw on the experience of Agway. This association has discontinued one of its large Buffalo, N.Y., feed mills because this mill was not geared to manufacturing bagged feed for a wide distribution area. With modern farm operations calling for bulk feed delivery from mills to farms, this facility no longer met the needs of its members.

Thus merger enables the cooperative to depreciate obsolete facilities and to more readily maintain those that adequately and effectively meet member needs.

Finance

A stronger financial position frequently can be achieved through merger. This often makes it possible to raise necessary capital at a lower cost.

An improved financial position, too, makes it possible to direct more resources to developing new products. This is especially important as it relates to the food lines marketing cooperatives handle. It has, however, equally important application to production supply and service cooperatives.

Obviously for cooperatives to get a reasonable share of this business will require especially strong financial resources--resources that cannot be

obtained by a number of independent and competing cooperatives going their respective ways. Financing, then, is closely related to other aspects of cooperative operation--for example, the facilities necessary to strengthen programs and to broaden services.

It is quite obvious, moreover, that it is only the strong and well-financed association that will be in a position to provide effective programs of personnel selection, training, and development; member relations; and public information.

Possible Disadvantages

It is a mistake to believe that all merger activities would be beneficial to farmers. Size is not an end in itself, it is but a means to an end. This introduces a concept also dear to the hearts of economists and is known as "diseconomies of scale." It suggests that under some conditions size may contribute to higher rather than lower costs.

Of course, we cannot consider diseconomies of scale without recognizing that many of the problems here are related to human behavior--a point considered later in this report. At this point it will suffice to say that the size a cooperative can achieve effectively is closely related to the competency of its management.

To illustrate, a cooperative grain elevator with an annual volume of 500,000 bushels may be too large a business operation for some managers to handle.

On the other hand, some managers are capable of effectively managing organizations doing hundreds of millions of dollars of business annually and providing a wide range of services covering many States.

The competency of management in working out problems of merger will determine the point at which effective operations give way to slow, cumbersome performance and the point at which efficiency gives way to inefficiency.

In some situations, scattered facilities or plants may make effective supervision and control somewhat

difficult. In other instances, bureaucracy and red tape actually contribute to increased costs.

Finally, legal considerations also relate to diseconomies of scale. While this is a fuzzy area at the present time, the courts, the Justice Department, and the Federal Trade Commission all have held that a merger will not be permitted when such action enables the firm concerned, cooperative or otherwise, to unduly enhance prices.

There is much misunderstanding on this point, particularly in the case of purchasing and service cooperatives, where there can be no logical reason for even attempting to exploit members by enhancing prices. We must recognize, however, that legal considerations are important and have a bearing on how far cooperatives may be able to go in realizing the objectives of merger. Specific legal problems of merger will be examined in detail later in this publication.

Observations

The merger studies we have made indicate that farmers could benefit to the extent of millions of dollars from cooperative merger. In fact, nearly every study showed that merger was the desirable course of action. While this does not apply to merger possibilities for all cooperatives interested in merger, it can be concluded that if economics alone were the critical factor the answer usually would be relatively simple--merger would benefit members.

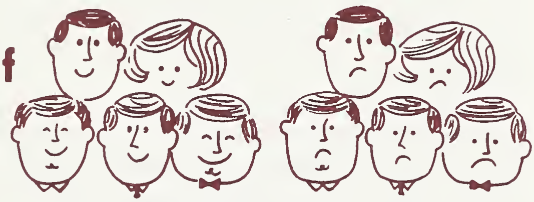
Our experience in cooperative merger studies suggests the following general observations:

1. Systematic thinking about merger requires first a careful evaluation of pertinent economic, political, and social considerations.
2. Merger usually offers opportunities for cooperatives to reduce operating costs.
3. Merger can give cooperatives increased bargaining power.
4. Merger makes it possible for cooperatives to improve and expand services.
5. Merger encourages the development of modern facilities.
6. Merger enables cooperatives to use their financial resources to better advantage.

7. Under some conditions, increased size from merging, however, can be a disadvantage to a cooperative because of the limited capacity of management and legal considerations.

8. Finally, cooperative leaders are coming to recognize, too, that merger generally is a more effective way than internal growth for acquiring increased volume, added lines of products, and more competent personnel--all important factors for cooperatives to consider if they are to compete effectively in the modern business economy.

Broad Aspects of Human Behavior



We have suggested that problems of merger if left to the field of economics are relatively simple. They can be evaluated quite objectively and decisions can be reached that are in the best interest of members. We must recognize, however, that cooperatives are organizations of people and as such depend upon their behavior. The groups involved are managers and employees, members, and the general public.

Rational and Nonrational Action

This brings us to a consideration of how human behavior may relate to problems of cooperative merger. We may ask ourselves: Do people act in a rational or a nonrational (reasonable or nonreasonable) way?

If we can assume that human behavior is rational and that people will look after their own best interests and those of society, our problem is relatively simple.

Many, however, believe that we are not justified in assuming that human behavior is always rational. They point out that people often act in a nonrational way--frequently people do not, in fact, act in their own best interests and that individual interests often

are contrary to the interests of the group of which they may be a part.

Let us take these ideas out into the cooperative business world since they have very real application to taking an objective look at mergers. First of all we should realize that man is a complex individual and that we do not understand too well the things that motivate him.

In fact, what has been called the iceberg theory has been developed to describe the nature of the forces motivating human actions. This approach suggests that, like the iceberg, not over 10 percent of the things that motivate people are above the surface and can readily be identified. Like the iceberg, too, this leaves 90 percent below the surface and hard to identify.

In any event, we can conclude that people respond in many different ways. Some are rational, some are not. Some are rational on some subjects but not on others. Some of the forces that motivate us are quite readily identifiable and some are not.

Members and Directors

In our studies of mergers, we have seen all kinds of behavior on the part of members and directors. Some were willing to put the interests of the organization first and their own special interests last. Others were not.

Some had a good understanding of the economic, political, and social forces shaping the environment in which cooperatives operate. Some did not, and, being suspicious of things they did not understand, they at times acted in nonrational ways.

Some, such as directors who might have been displaced in merger, were motivated more by what a merger would do to them as individuals than what it would accomplish for their neighbors and the community in which they lived.

When we look at the actions of members in a cooperative, we find evidence to support both the rational and the nonrational explanation of human behavior. In some instances, members are ahead of both directors and employees in seeing the implications of change as they apply to their cooperatives. In others, competition between cooperatives, confused thinking as to the

relationship of cooperatives and general farm organizations, and failure to properly appraise changes in farming, all are forces that stand in the way of realistic thinking and action on problems of merger.

An understanding of human behavior and the things motivating people, while applying to all types of activity, has special application to cooperatives because of the close man-to-man relationship necessary for their successful operation.

Employees

Many of the same rational and nonrational behavior traits apply to employees as well as to members and directors. Are employees oriented to the basic objectives of cooperatives or do they put their immediate and personal interests first? Are they willing to adjust to change or are they like the person who said he had seen many changes in his day and that he had been against everyone of them?

It is quite natural that many managers and key employees fear for their jobs and give little or no attention to the interest of members when evaluating merger prospects.

While you may say this is rational self-interest, this approach often is contrary to the interest of farmer-members and, more often than not, contrary to the long-range interests of most employees as well. If merger results in only some of the benefits claimed, it quite obviously will open new and enlarged opportunities for many employees. The problem is that these advantages are in the future, they mean change and adjustments, and they are not as immediate as the threats that merger appears to have for their individual interests.

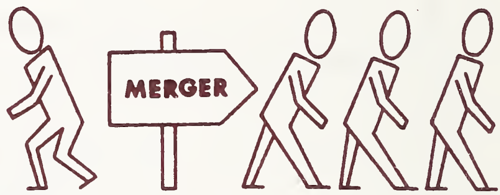
General Public

Public behavior, too, is of interest to cooperatives. The public can be encouraged to support or oppose cooperatives. Public reaction is very important; witness the propaganda efforts of those opposing cooperatives.

It is important to keep the general public informed. If people understand about cooperatives--their objectives, operations, and accomplishments--cooperatives

should have little fear. If they have such understanding, cooperatives can expect more rational behavior in the reactions of the general public. They would realize, for instance, that the farmer, just like the city businessman, needs larger firms to represent him in the complex markets of today. This would serve to discredit the old cliches often repeated by nonfarm people to the effect that small cooperatives are all right but large ones are dangerous.

Practical People Problems



People are more involved in cooperatives than in most other businesses because of their member-owner-patron relationships. This introduces many practical problems in people-to-people relationships when merger is attempted.

As mentioned, people do not always act rationally or logically, or for their own best interests. Sometimes they are described as emotional, biased, prejudiced, jealous, selfish, narrowminded, shortsighted, or cynical.

But even the good attributes of people can sometimes cause problems in merger. These attributes can be: Pride--in something they have built or organized; status--their position of leadership or power; security--they want to keep their job; confidence--in their local manager and employees; a desire for convenient service--from nearby facilities.

With a full realization of these very practical "people problems," cooperative leaders must find ways to minimize or overcome them. We are confining the discussion here primarily to the problems in getting approval of a merger rather than to those encountered after the merger.

Not all of these problems occur in any one merger and some may be much more important in some mergers than in others. Some are more common to

regionals than to locals. As we see it, they break down into six major areas now to be discussed: Attitudes toward merger, pros and cons, key personnel, employees and facilities, director representation, and membership requirements.

Attitudes Toward Merger

Unless directors and managers are willing to discuss and study the need and feasibility of merging, the whole issue never gets considered, never gets to the membership.

Thus, the first step is to be openminded and willing to consider alternatives in an honest, objective manner.

If directors have such an attitude, then rapid progress often can be made. For example, in case the manager of one association leaves for any reason, the board could appoint an acting rather than a permanent manager; and it might arrange with a nearby association for its manager to serve as manager of both until a merger could be brought about.

What can be done about getting people to even consider a merger? This is largely a matter of providing information--using the educational process. This may come about by getting people to read articles, attend meetings, and talk with other directors and managers of associations that have merged.

Actually this is not as much of a problem today as in the past. For merger is in the air; the climate for it is "fair and warmer." And here again lies danger. Some people say too many are getting on the merger bandwagon--rather than first analyzing each case on its merits and determining if there would be real benefits from combining.

Pros and Cons

Most directors and managers have never been through a merger before and thus have no experience as a basis for judging the pros and cons of a merger.

Directors, managers, and members want to know the probable advantages and disadvantages of a proposed merger, and especially how it is likely to affect their association and members. They want to know what both the short-range and long-range effects or benefits in savings, services, financial strength, and

growth may be, say 1 year and 5 years after merging. These effects were discussed earlier.

They also would like an appraisal of the possible disadvantages if they merge into a much larger organization. They may have questions such as these:

1. Will members have less direct control or lose some of their independence or freedom of action in the larger, unified association?

2. Will communication between the cooperative and members be more difficult?

3. Will a cooperative with several branches be practical? Will it be too difficult to manage--to satisfy members around each branch?

4. Will some key employees leave because they will not retain as much status or believe they will not be able to advance as fast in the merged association?

None of these questions are easy to evaluate and answer. We have found, however, that problems in member relations from increased size are more likely to arise when two regional cooperatives merge than when two locals merge.

We also need to consider the effect of statements people may make about the disadvantages of merger, including those people from outside the cooperative who believe a merger may adversely affect them. The seeming confidence and forcefulness with which those persons opposing a merger may present their arguments often cause real problems. They usually are much more sure of the disadvantages than the others are of the advantages.

What then can be done to get an objective estimate or evaluation of the probable pros and cons?

Two cooperatives may appoint representatives to serve on a merger committee to study the proposal. It usually will have to rely on employees from each association to develop information. If local cooperatives are involved, they might obtain suggestions from their regional cooperative or district bank for cooperatives. A university or Farmer Cooperative Service also may be helpful.

Another approach is for the committee or the full boards to have a study of the feasibility of merger made by an outside agency such as a university, Farmer Cooperative Service, or a management consulting firm.

Then in either case, the committee or boards will have to discuss the findings and determine whether merger likely would be in the best interest of farmer-members rather than to look at it strictly from the viewpoint of the present cooperative institutions.

Even if a study shows possibilities of substantial savings or other benefits possible from a merger, there still may be objections or questions of a non-economic type. There may be doubts or reservations in the minds of members that can create problems--whether real or imaginary.

Key Personnel

Completion of a merger probably depends more often on an understanding of what will happen to the managers of each association than on anything else. If a manager opposes a merger, he usually can block it.

Directors are often hesitant to override their manager or have trouble being objective in handling personnel problems. Directors also may not feel completely confident that a merger will produce all the benefits claimed for it.

Among larger cooperatives, this problem frequently can be solved by reaching an understanding that one of the managers will become general manager and the other an assistant manager or department head in the merged association. Sometimes a 1-, 3-, or 5-year contract may be given to the manager to give him security and to assure members that the merged association will have the benefit of his experience and ability.

Not only is the approval of managers frequently necessary for accomplishing mergers, but in some cases it greatly expedites action. For example, recently three mergers involving cooperatives in the West took place. The climate among the directors of these organizations generally was receptive to considering unification.

Therefore, the general managers and office managers took the lead in studying possibilities and developing plans. They analyzed possible savings and developed procedures for the exchange of equities,

operating policies, board representation, and the handling of key personnel.

After consulting with attorneys, accountants, and bankers on ways of handling legal and financial problems, they made recommendations to each board of directors separately and received the approval of each before holding joint board meetings. The general manager of the combined organization reported that this procedure expedited the mergers and kept the boards from getting too involved in tradition and sentiment.

A strong feeling exists among some cooperative leaders, however, that no premerger agreements, such as selecting key personnel, should be made. They point out that these may seriously limit the ability of the new board and manager of the merged association to effectively discharge their responsibilities.

Employees and Facilities

The question of excess employees is of special concern in merging cooperatives. Many employees naturally feel insecure about the prospects of a merger because, unless there is a good potential for growth, some reduction in personnel may be necessary in the combined association if savings are to result.

In addition, decisions may be necessary regarding policies of employee tenure, severance pay, and fringe benefits to get them on the same basis in a unified cooperative.

Sometimes associations involved in mergers have guaranteed employment to all regular personnel in the combined association for a specified period such as 6 months or a year. This may reduce potential savings and limit the authority and flexibility of the general manager of the combined association for a period, but it helps to accomplish mergers.

In some cases, the problem of excess personnel may not be serious. Attrition may largely take care of the situation as some employees may soon be retiring, and others may seek employment elsewhere after appraising their opportunities in the merged association.

Representatives of a large regional cooperative in the Midwest encourage its local cooperatives to look at the prospects for growth from merging rather than at the immediate savings that can be made from eliminating duplication of positions.

Studies often indicate that the same number, or even more employees, will soon be needed in a merged association. This may mean projecting no reduction in employees, except that from normal attrition, and hence little additional savings the first year or two. But within 5 years, a larger volume per employee, lower expenses per dollar of sales, and higher net savings per dollar of business would be expected.

The problem of handling excess facilities also should be deferred until after the merger has occurred in order to avoid concern among employees and members.

Director Representation

A problem sometimes arises when there is a considerable difference in size of associations or in the size of their boards. A board made up of the total directors of the two cooperatives would probably be too large, but some directors may not relish the thought of relinquishing their position in order to have a smaller board for the merged association.

What may be done? Frequently provisions are made for all of the directors of both associations to serve on the board of the merged organization for a predetermined time, or until the terms of a certain number of existing directors expire, and for a smaller number to make up the board thereafter. Agreement also is reached as to how the reduced number will be nominated and elected.

Here again this may be a cumbersome but necessary arrangement to get a green light for the merger. Positive support and an enthusiastic attitude on the part of directors are important; each will go a long way in getting approval of the membership for merger. Such action is especially necessary where members are community-minded and rivalries or jealousies exist between the two cooperatives involved, or between the two towns in which they are located.

Membership Requirements

A number of problems may arise in this area. Membership requirements in terms of amount of capital investments and use of marketing contracts often differ.

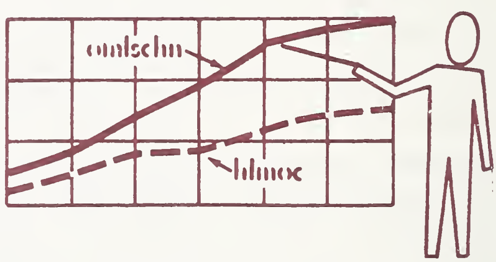
One cooperative may have a provision that membership in a general farm organization is necessary for membership in it and for participation in its patronage refunds, while the other cooperative involved in the merger may have no such provision.

Or members of one regional cooperative may be individual farmers, and members of the other may be local cooperatives.

The question of voting provisions may arise in some States as more associations inquire about the advisability of voting on the basis of patronage or volume instead of the traditional method of one vote per member.

These then are some of the very practical "people problems" involved in mergers. Differences have to be resolved but usually they are not important obstacles if the directors and members are really serious about merging and willing to compromise.

Financial and Economic Problems



Cooperatives merge with the intention of expanding assets, realigning liabilities, broadening services, reducing expenses per dollar of business, and realizing greater net savings for their members. This section discusses some of the problems and methods in developing a unified association that will attain these objectives.

Financial Benefits

How much additional net savings are likely to result from a merger? Will a financially stronger cooperative result? How much of these added savings and

financial strength will accrue to our members versus those of the other cooperative or cooperatives? Will the rate of patronage refunds on certain commodities or on all volume be larger or smaller than in our cooperative?

These are among the first questions directors and members ask when considering a merger. Answers are difficult to determine accurately and confidently.

Estimates or projections should be made for the second year and sixth year after completing a merger. Also for comparison, estimates should be made of probable net margins for each cooperative if they do not merge. During the first year, there will be extra costs from merging such as legal, membership meetings, issuing new capital stock or other evidences of equity, and consolidating facilities or remodeling the headquarters. Also competition from other firms may become keener. Or eliminating duplicate facilities, personnel, and other operating expenses may be delayed the first year. Therefore, results estimated for the second year after merger usually will be more realistic and typical.

Then estimates of additional savings and financial strength 3 or 5 years later should be made after the effects of reduced expenses, more competent management, elimination of duplication and competition of the merged cooperatives, and larger net margins have had ample time to exert their influence.

Such estimates will have to be based on some assumptions or value judgments. They will require considerable study and analysis by a merger committee, managers and accountants, or an outside agency, or combination of these. Every effort should be made to develop objective and conservative estimates of what the cooperatives likely will do if they merge and if they do not merge.

Assets and Equities

Often the question arises as to whether the book value or an appraised value of the assets should be used.

This problem may occur where one association has a larger amount of receivables--either in total or in the percentage that is old and of doubtful

value, or where the market value of land or buildings is higher than its book value because of its location for commercial use.

Unless the property is located in an area where commercial values have increased greatly or unless accounting methods vary greatly, the use of book values of assets usually is advisable to eliminate extended negotiations, extra expenses, and possible bottlenecks. Usually the combined organization would continue to use the properties rather than to liquidate them and realize capital gains or losses.

In the case of acquisitions, however, an appraisal may be necessary. This may pose a question of the fairest manner of handling capital gains if some are involved. Capital gains may have to go to the holders of outstanding common stock, or to the holders of membership certificates in a nonstock cooperative. This can cause membership problems if most of the equities of the association are represented by recently acquired revolving fund capital.

The bylaws of many cooperatives and State cooperative statutes do not specify the rights of equity holders when capital gains or losses occur as a result of the disposition of assets in mergers, consolidations, and acquisitions.

In the past, cooperatives usually were not concerned about dissolution provisions because those that sold out or liquidated seldom had any member equities left. But with merging and acquisition activity increasing, cooperatives need to see that dissolution and merger provisions are included in the bylaws applicable to their present situation.

Liabilities and Risks

A problem sometimes arises if Cooperative A has little or no indebtedness and Cooperative B has a relatively large amount. Members of Cooperative A may hesitate to assume additional liabilities, or they may believe that their patronage refunds will have to be deferred or issued in stock in order to meet the payments on notes or mortgages after merging.

Likewise, if one of the cooperatives has a more risky operation or a record of declining net margins or occasional losses, members of the other may hesitate to assume the risks of the first association.

Each case has to be analyzed separately and judgments made as to the probable future operating ability of a merged association.

In some cases it may be expecting too much of the stronger association to assume the liabilities and risks of the weaker one.

Member Equities

Frequently two or more associations considering merger will have different capital structures and policies for revolving member capital.

Cooperative A may have common and preferred stock and Cooperative B only common stock. Or the dividend rate on the preferred stock of Cooperative C may be higher than that of Cooperative D.

If the amount of preferred stock is small in relation to the common stock or if the extra amount of dividends on the higher preferred stock is small, the outstanding stock of each type may be brought intact into the merged association. The same policies would be continued with each until it could be retired or voluntarily exchanged for another type of member equity. Otherwise it may be necessary to assure Cooperative B's members that some preferred stock will be issued to them in the merged association, or to assure Cooperative D's members that their preferred stock will be exchanged for higher dividend stock in the unified organization.

The same situation would apply where one cooperative has a much larger unallocated surplus or general reserve in relation to its capital stock than does the other association.

Also, agreement will be necessary as to how the surviving association will pay the other cooperative for its equities. Whether cash payment is to be in a lump sum or amortized is important if capital gains are involved.

If cooperatives have revolving capital with different redemption or maturity dates, premerger agreement may be needed as to whether such capital will be transferred to the merged association as is, or whether certificates on a 5- or 7-year plan can or should be exchanged for certificates that do not have a set period of rotation.

In some cases, when equities are exchanged in a merger procedure, the capital structure can be simplified. One suggested method is to distribute one share of common voting stock to each eligible member and the remaining equities in some form of non-voting stock or allocated capital reserve that retains its original order of redemption.

These and similar questions may be resolved in various ways if leaders will approach them from the standpoint of building a stronger cooperative for the future rather than trying to attain complete equity for members of each cooperative at time of merger.

Name, Brands, and Policies

Members of one cooperative may be reluctant to lose the identity of their association and its product brand name--in other words, the image it has worked hard to build over the years.

The surviving association would like to maintain this image and the goodwill of the patrons of the other organization. Therefore, the boards of the associations considering merger may try to reach an understanding as to what the name of the merged organization will be. Also they may agree that existing brand names of each will be continued in the combined association for a specified period of time.

Premerger agreements about major operating policies and duplicate facilities, however, should be kept to a minimum to avoid premature announcement of changes in services and policies which may impede merger approval. Also, the future board of directors and manager should not be limited in their actions by existing associations, if at all possible. However, in some cases, assurance that certain plants or services will not be discontinued for a specified period may be advisable.

Differences in major operating practices also may need to be resolved--such as deciding whether or not to operate on a Federal income tax-exempt basis; whether to use marketing contracts with members; or whether to distribute supplies from a central warehouse or plant largely by truck or mostly on a pickup basis from retail branches.

Legal and Corporate Problems

Many persons place legal and corporate aspects near the head of the list of problems to resolve--especially when regional associations are merging. Compliance with State statutes is necessary with respect to merger procedures, member approval, dissenting members, financial aspects, and the like.

Method of Combining

Somewhere along the line, a decision has to be made as to the most appropriate method of unifying--whether to merge one association into another, to consolidate two or more and form a new association, or whether one association should buy the assets of the other.

Cooperative officials often report that it is easier to use the acquisition route where a larger, stronger association buys the assets of the smaller association. In the case of the acquiring association, usually only a majority vote of the directors is necessary, although the subject may first be discussed at a membership meeting. For a selling association, approval of its membership is required.

Regardless of the method of combining used, membership and public relations should be carefully considered. The choice of words should indicate that the associations are combining, unifying, merging, or consolidating, rather than that Cooperative A is buying out or taking over Cooperative B, or that Cooperative B is selling out or becoming a branch of Cooperative A.

Corporate Structure and Bylaws

Agreement may be necessary as to the type of capital structure or form of member equities, and the terms and conditions applicable to each. This includes the types and par value of preferred and common stock, minimum number of shares required per member, rates of dividends to be paid on each, types and forms of allocated member and patron equities, and the like.

Where the capital stock of each association bears different rates of dividends, a question may arise as to the future rates to be paid--at least until such time as the existing stock is retired.

Other items to be resolved may be the use and terms of other securities such as debentures and certificates of indebtedness.

Agreement also will be needed as to amendments to articles of incorporation and bylaws covering the points discussed and many others.

Plans and agreements for a proposed merger are usually prepared and then resolutions approving the agreements affirmed by each board of directors involved. Members of each organization then vote on adoption of the agreement. It must be accepted by a proportion of the members--ranging from a simple majority to a three-fourths majority. Statutory provisions covering rights of dissenting stockholders, if any, must also be studied carefully.

General suggestions regarding structure and bylaws are difficult to offer. Much often depends on the personal preferences of directors, managers, auditors, and bankers, and the historical policies of the associations. As a rule, simplicity and flexibility are desirable. Dividends should not be cumulative and exceptionally large amounts of liabilities should not become due at one time nor in two successive years.

State and Federal Statutes

Since statutes vary among States, directors and managers should obtain an early understanding of them to avoid problems in later stages of merger negotiations. Some State cooperative laws do not contain provisions for merger or consolidation procedure. This means the general corporation laws have to be

applied, and the manner of their application may not be clear. Also, articles and bylaws of cooperatives usually do not have any sections regarding merger procedures.

Under some State laws, the equities of all members that cannot be located shall revert to the State in case of dissolution, merger, or other form of unification. In a few cases, this has become a serious obstacle to combining with another association.

Consideration also should be given to the Federal income tax laws in order to ascertain proper compliance and to obtain all possible benefits. If the organizations involved have qualified as so-called "exempt" cooperatives as defined in Section 521 of the Internal Revenue Code and have in fact been operating as exempt cooperatives, the effect of the proposed action on their tax status must be considered and a determination made as to whether it will be affected by acquisition or combination.

Compliance with antitrust laws and regulations is especially important to regional cooperatives. An article in the News for Farmer Cooperatives, April 1961, points out:

"The principal points to keep in mind are: (1) That mergers or acquisitions are precluded only where there is reasonable probability that a substantial lessening of competition or a monopoly might result within an area of effective competition, and (2) the market affected must be substantial and it must appear that competition may be foreclosed in a substantial share of that market.

"Accordingly, if a cooperative acquires necessary facilities for business use through methods legally sanctioned and the acquisition does not have the prohibited effect on competition, it is believed that the provision in the Capper-Volstead Act would furnish support for the acquisition."

Cooperatives desiring to merge will need legal counsel. Local cooperatives can get information or assistance on these problems from local attorneys, their regional cooperative, or their district bank for cooperatives.

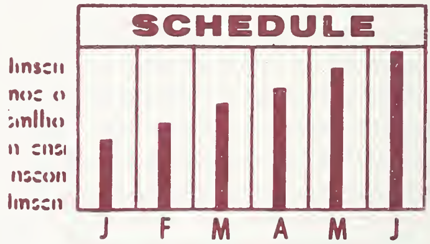
Dissenting Members

This may be considered as a "people problem" but here it is discussed largely from the financial angle.

In some States, holders of each class of stock in cooperatives, as well as other corporations, are given voting privileges in case of mergers, consolidations, or sale of assets. Also provisions regarding the right of dissenters to receive payment for their stock vary among States. These are legal points that should be checked into.

In addition, participants may wish to consider the practical or membership relations aspects. For instance, in the Midwest where unification usually occurs through the acquisition method, local cooperatives often try to retire the equities of dissenters before the merger proposition comes before the membership for a vote. This avoids spreading much antimerger information before and during the meeting or during the period when mail ballots are coming in. In some States this has been done as a matter of policy even though State merger statutes do not require voting by classes of stockholders or payment of equities to dissenters.

General Considerations



This section covers steps in merging cooperatives and some attributes of directors and managers that will be of much help in resolving the various problems that have been discussed.

Timing and Scheduling Steps

Steps in merging cooperatives may be broadly grouped under four stages--the idea stage, the study stage, the proposal and compromise stage, and the

member approval stage. Members and employees usually find out about proposed mergers quickly and so it is important that they be given some information about studies underway. Facts help reduce rumors.

Premature release of information to either party, however, can cause difficulties. Also, progress in merging can be impeded if the merger committee or the boards discuss too early such topics as assigning key employees, selecting a new name, closing plants, or changing services.

Careful attention to the timing of these actions and to the type of information provided to members will help avoid problems in getting member approval of mergers.

Objectivity and Statesmanship

Members look to directors and managers to study the probable advantages and disadvantages of a merger and to make recommendations. If problems or obstacles are to be avoided, minimized, or overcome, and members' best interests are to prevail, we believe cooperative leaders should strive to:

1. Keep an open mind.
2. Look at the problem from both sides--from the viewpoint of the other cooperative as well as their own.
3. Give more weight to probable long-range advantages than to immediate benefits.
4. Be willing to compromise. This may mean the difference between a merger and no merger. Neither association, especially the larger, stronger one, should insist on the "last pound of flesh." At the same time, care needs to be taken that agreements or commitments that help accomplish merger do not tie the hands of the new board and manager.
5. Exhibit statesmanship--by doing what appears best for all farmer-members in the area. If the going gets rough, be patient but keep on plugging. The only sound and lasting solution is that which will most effectively serve the owner-users of the cooperatives.

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Farmer Cooperative Service provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

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